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"This week, our leaders have a chance to make the world anew"

More than 60 years ago in New Hampshire, the world's economies were recast. Now, as they lie in ruin, Gordon Brown must inspire those meeting for Bretton Woods II.

Will Hutton*

The most important economic summit for a generation begins in Washington next Saturday. The leaders of the major industrialised countries, China, Russia, Brazil and India, along with the heads of the IMF, UN, World Bank and EU meet to discuss how to reform and then govern the international financial system. Summit aims do not get any more ambitious.

Fundamental questions are being raised about how capitalism is to be organised. It will be an achievement if, next Saturday, they get beyond agreeing on core principles and a commitment to talk more. But urgency is vital. The EU forced the pace by declaring on Friday that the summiteers should come up with answers within 100 days.

It is an ambitious deadline. It took nearly two years of discussion before there was sufficient agreement to attempt the 1944 Bretton Woods conference that established the postwar international financial system and to which this week's summit is being compared. But shared awareness that the system is broken and that we risk a global depression is concentrating minds.

Where to start? The architects of Bretton Woods knew they had to avoid the beggar-thy-neighbour policies of the Thirties and that if Britain and the US could clinch a deal, then everybody else would have to follow. Even then

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it was a struggle. The question then, as now, is: how much are governments prepared to pool economic sovereignty and accept economic disciplines in order to produce the greater global public good? The American answer was not much. The US only agreed to the IMF managing a system of fixed exchange rates if the US in effect ran it. The dream of creating a system of global financial governance was passed up. Realpolitik had triumphed.

The system then only lasted as long as the Americans thought the benefits of running it outweighed the costs. When, in 1971, the Nixon administration was faced with the choice of increasing taxes to finance the Vietnam War or abandoning the Bretton Woods fixed-exchange-rate system that delivered predictability and less risk in international financial relationships, it had no hesitation. The markets would do the job instead and if other governments did not like the new risks, tough.

For a long time, it looked as though private markets could step into the breach - recycling first petrodollars in the 1970s and latterly Asian dollars back into the global system. Floating exchange rates were volatile, but instruments such as markets in future exchange rates emerged to manage new risks. There might be serious ruptures, like the Eighties' Latin American debt crisis or the Nineties' Asian financial crisis, but basically governments could step away from global economic management. The markets would do the job.

Now we know they cannot. The crises of trust and out-of-control speculation that wrecked Latin America and Asia have now attacked the system's core in the US and Europe. The system proved unworkable. In good times, uncontrollable flows of private lending created massive asset price bubbles. In bad times, nearly $3 trillion of loan losses have overwhelmed the capital of the Western banking system. Tsunamis of speculation in a $360 trillion global financial derivatives market, allegedly hedging risk, mean that everything - currencies, interest rates, share and commodity prices - swings unstably, irrationally and incredibly quickly, beyond the capacity of actors in the real economy to react. The system is devouring itself.

Emergency action has stopped the collapse of Western banks, but now there is a dual challenge. It is to design a new system, while trying to make sure that the disastrous legacy of the broken system does not drag the world into depression. And unlike 1944, there are many more interests to be brokered into a common position. There is the US still not willing to pool sovereignty. Britain will pool sovereignty, but not to the degree it will join the euro or become part of a European regulatory regime. Europeans, led by President Sarkozy, want an attack on laissez-faire finance, to restrict sovereign wealth fund activity and propose systemic regulation. China wants to contribute as little as possible while being free to rig its currency to promote its exports. Opec countries and Russia want the freedom to invest their $2 trillion of sovereign wealth funds where they choose. Japan wants to stop the yen from becoming wildly uncompetitive. Less-developed countries want more voice and more money, but accept no responsibility for managing the system. All have a different conception of how to do capitalism. All jockey for individual advantage. All want somebody else to make sacrifices for the common global good. Meanwhile, most financiers remain in a state of denial about what has happened, resenting government support and desperately hoping that they can get back to the freewheeling old days as soon as possible. Change must be minimal. The auguries for agreement do not seem great.

Yet there are contrary forces. Policy makers are terrified. For the first time, the US has realised that it can no longer square the circle of simultaneously mounting expensive foreign wars and domestic booms by freely borrowing other countries' dollars. The consequent debt and volatility have broken the US's financial system. The US is now in the same position as Mexico in 1981 or South Korea in 1998. It is becoming part of a new consensus that accepts that governments have got to organise the world's financial system so there is less systemic risk. Moreover, governments must also ensure that the market mechanisms devised to handle risk, like the derivatives markets and the capital base of the banking system, are better managed. There is no alternative. It's the only way banks can return to their core mission - lending to business and households around the world.

Here, Gordon Brown has a major opportunity to build on his newly won reputation as a decisive economic leader and to do some real good. He is right to propose that the role and finances of the IMF are beefed up massively. We now live in a world in which private capital flows run into trillions of dollars, yet the IMF has only $250bn of lending power. It needs up to a trillion dollars, as does the World Bank. Brown has won Saudi commitment to replenish the IMF's coffers and begun to get some real momentum. Equally, his call for a co-ordinated global fiscal injection of funds is also right, as is his desire to create a college of international regulators.

So far so good, but his capacity to emerge in pole position as the summit's broker depends on going much further. For a start, Britain should take a lead by declaring we are prepared to offer the IMF up to £25bn and persuade the Europeans to do the same. Brown should also go back to Bretton Woods basics. He should propose the end of floating exchange rates and argue for a system of managed exchange rates between the euro, dollar and yen to bring back more predictability into the system. The American, EU and Japanese governments would undertake, as in the first Bretton Woods, to take whatever economic action is needed to maintain stability between their exchange rates. He should be uncompromising about the need to end the destabilising role of tax havens as sources of dodgy lending and tax avoidance.

Then there is the matter of improving the financial system's own risk-handling mechanisms. Here, Brown's position is less robust than it should be. He advocates more effective cross-border financial regulation, but not so much as to endanger the City's standing as home of minimal regulation. He must change tack. For example, he should take the lead in proposing that the global trade in financial derivatives be organised in licensed exchanges.

And having led the way in requiring banks to recapitalise themselves, he should now block Barclays's plan to do so with very expensive sovereign wealth fund cash, a proposal that is scandalising Barclays customers, shareholders and other Western governments. Banks everywhere are wondering whether they should follow Barclays' behaviour and focus on repaying government funds fast, so undermining the entire global recapitalisation exercise and prioritisation of new lending. Instead, Barclays should be obliged to take government cash like the rest of the banks.

There is a Bretton Woods II deal to be done. The EU, Americans and Japanese accept the need to strengthen the IMF. There is also a strengthening will to organise the financial derivatives markets into global exchanges and to influence the price at which these gambling chips change hands.

But this is only a fraction of what is necessary. There needs to be a paradigm shift towards greater acceptance of global principles, rules and governance by both banks and governments. We need global rules on the terms and means by which banks are recapitalised and how banks are bailed out of their bad loans. Banks need to accept that the world has changed. We need global rules on hedge funds, tax havens and derivative trading.

And we need Western governments to give a lead in taking the risks from the system by declaring their willingness to manage the values of their currencies. This is what we need. Brown's task is to make sure the world gets it.

The views expressed in this article are those of the author and do not necessarily reflect those of the FES London.

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